BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
1998 Biennial Regulatory Review -	)	
Review of Depreciation Requirements	)	CC Docket No. 98-137
for Incumbent Local Exchange Carriers	)	
	)	
Forbearance from Depreciation Regulation	)	ASD 98-91
of Price Cap Local Exchange Carriers	)	

REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL

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Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell
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Summary*

Given that price cap regulation provides protection against price increases resulting from changes in depreciation, it is not necessary for the Commission to find sufficient competition before it ceases regulating depreciation. Some of the non-ILEC commenters contend that depreciation regulation is still essential for several regulatory processes identified in the NPRM, such as the low-end adjustment or price cap performance monitoring. However, the ILECs have explained in detail why depreciation regulation is not necessary for any of these situations.

Ad Hoc and Florida even concede that depreciation regulation is not a significant concern in most of the situations described in the NPRM, except the low-end adjustment and takings clause claims.

AT&T and MCI contend that it would be impractical to review depreciation at the time of any low-end adjustment filings. On the contrary, there is ample time during the five months of an access filing investigation to review the general reasonableness of an ILEC's depreciation rates.

AT&T and MCI share a concern that the Commission could not effectively monitor ILEC earnings for purposes of price cap performance reviews or adjustment of the X-Factor without continuing to prescribe depreciation rates. However, individual company earnings levels are not supposed to be relevant under price cap regulation. The X-Factor is to be adjusted based on industry-wide performance or other generic factors. Further, the Commission's prescribed depreciation rates do not provide an accurate measure of depreciation or earnings.

AT&T and MCI claim that GAAP would not be an adequate substitute for prescription of depreciation rates, because they contend that GAAP, being governed by the principle of "conservatism," is biased against consumers and in favor of understatement of net income and assets. AT&T and MCI have a fundamental misunderstanding of not only "conservatism," but also of the role GAAP plays in financial reporting. Through a number of principles that govern

* The abbreviations used in this Summary are defined in the body of these Reply Comments.

depreciation, such as the matching principle, GAAP ensures that a company does not present a misleading picture of its financial condition. Conservatism in financial reporting no longer connotes deliberate understatement of net assets and profits.

Contrary to AT&T and MCI's contention that there is a depreciation reserve surplus, the Commission's backward-looking prescribed depreciation rates have created a large depreciation reserve deficiency. Continuing to regulate depreciation only exacerbates the problem; whereas, forbearance from regulation shifts responsibility for any new deficiencies to the ILEC. Ad Hoc's "Make Hole or Make Money" proposal is severely flawed because it would not permit the ILECs to make any money and Ad Hoc incorrectly assumes GAAP would require ILECs to forego recovery of billions of dollars of depreciation reserve deficiencies.

It would be a poor policy decision to eliminate net salvage from depreciation at this time. First, at a time when the Commission should eliminate depreciation regulation altogether, it makes little sense to adopt such a fundamental restructuring of the depreciation requirements. Second, treating net salvage as a current expense would be contrary to the GAAP procedure proposed in Exposure Draft 158-B. And, the impact would not be trivial as alleged by MCI. Aside from forbearing from prescribing depreciation rates, the Commission should not proceed with a significant and conflicting change in the treatment of net salvage.

The NPRM does not reflect the comprehensive review of depreciation requirements and basic factor ranges that is essential should the Commission continue to regulate any ILEC's depreciation. To the extent that the Commission does not grant forbearance, the SBC LECs urge the Commission to undertake a comprehensive review of the basic factor ranges, based on forward-looking data and recent and future developments, rather than focusing on historical retirement and mortality data.

However, it is unrealistic to expect the Commission to keep up with the rapidly changing dynamics affecting ILECs' depreciation practices. Depreciation rates quickly become outdated if they are not reviewed annually and the Commission's massive depreciation procedure is not an

effective method of keeping up. Accordingly, the Commission should remove itself from the depreciation process and rely on independent auditors and GAAP to assure the reasonableness of depreciation.

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REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL

Southwestern Bell Telephone Company, Pacific Bell and Nevada Bell (the "SBC LECs") hereby reply to the comments filed on November 23, 1998 pursuant to the Commission's Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding.

I. ILEC COMMENTERS HAVE PROVEN THAT DEPRECIATION PRESCRIPTION IS NOT ESSENTIAL UNDER PRICE CAP REGULATION.

AT&T, MCI and Ad Hoc[1] contend that the Commission should continue to regulate the depreciation practices of price cap ILECs until there is sufficient competition.[2] For example, AT&T states that, "Given such an overwhelming market position, the Commission properly concludes that the time has not yet arrived when it can safely dispense with depreciation regulation."[3] This line of reasoning does not apply to price cap ILECs. What these commenters fail to recognize is that price cap regulation in-and-of-itself provides sufficient protection against price increases resulting from changes in depreciation, such that it is not necessary for the

[1] A list of commenters is attached as Appendix A.

[2] AT&T at 12-13; MCI at 3-4; Ad Hoc at 2-4.

[3] AT&T at 13.

Commission to find "sufficient" competition before it ceases regulating depreciation. As NERA stated in its Affidavit, "the degree of competition in local exchange markets is not pivotal for the decision at issue here."[4] In fact, elimination of burdensome remnants of rate-of-return regulation, such as depreciation regulation, was one of the main purposes of price cap regulation. Likewise, elimination of sharing in 1997 was intended to further sever any connection between prices and costs so that "administratively burdensome" rate-of-return regulations could be eliminated.[5] In eliminating sharing, the Commission observed that "sharing might be a serious impediment to deregulation."[6] The Commission also stated that "elimination of sharing reduces our reliance on, and thus the importance of, jurisdictionally separated embedded costs."[7]

Despite the greatly reduced importance of book costs, some of the non-ILEC commenters contend that depreciation regulation is still essential for the several regulatory processes identified in the NPRM. For example, MCI claims that even under price cap regulation, depreciation still plays "a key role in the ratemaking process."[8] In their comments, the SBC LECs and the other ILECs have shown that it is not necessary to retain the massive depreciation prescription process for any of the purposes identified in the NPRM.[9] By eliminating sharing,

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[4] USTA, Attachment A, at 9. While competition is not pivotal to the main issue, if the Commission conducts a comprehensive review of its basic factor ranges, analysis of the level of existing and imminent competition shows that the low end of the life ranges needs to be reduced significantly. See, e.g., SBC LECs at 19-23 & Exhibit A at 13-19; USTA, Attachment A at 6-9; Ameritech at 9-11; BellSouth at 10-11; GTE at 12-16.

[5] 1998 Biennial Regulatory Review – Part 61 of the Commission's Rules and Related Tariffing Requirements, CC Docket No. 98-131, Notice of Proposed Rulemaking, FCC 98-164, released July 24, 1998, n.23.

[6] Price Cap Performance Review for Local Exchange Carriers, 12 FCC Rcd 16642 ¶151 (1997) ("1997 Price Cap Review Order").

[7] Id. ¶152.

[8] MCI at 2.

[9] See, e.g., SBC LECs at 6-16; Ameritech at 6-9; Bell Atlantic at 5-10; BellSouth at 15-24; USTA, Attachment A at 13-19.

the Commission has eliminated the only remaining significant obstacle to depreciation deregulation and has virtually taken depreciation out of the price cap ratemaking process. In the remainder of the situations identified in the NPRM, either the impact is *de minimis* or the general reasonableness of depreciation can be reviewed on a case-by-case basis if the situation happens to occur.[10] The SBC LECs and the other ILEC commenters have explained in detail why depreciation regulation is not necessary for any of these situations.[11]

The NPRM and the non-ILEC commenters suggest that all price cap ILECs should continue to be subject to full-blown depreciation regulation to prepare for the possibility that one of them may seek a low-end adjustment or above-cap rate.[12] As the ILEC commenters have shown, such anticipatory regulation is no longer necessary and is certainly not an efficient approach.[13] First, GAAP and external auditors provide assurance that depreciation rates will be reasonable. Second, the Commission can retain the right to review depreciation rates at the time of any such future requests. In fact, if the low-end adjustment is eliminated, as suggested in CC Docket 96-262, then there would be very limited reason to even look at depreciation on a case-by-case basis.

By their arguments, Ad Hoc and Florida even concede that depreciation regulation is not a significant concern in most of the situations described in the NPRM.[14] Florida recommends that price cap ILECs be allowed to set their own depreciation rates subject only to their

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[10] See, e.g., SBC LECs at 3-16; Bell Atlantic at 3-9; USTA, Attachment A at 13-19.

[11] Id.

[12] AT&T and MCI incorrectly assume that the NPRM's meager simplification proposals would significantly reduce the burden of depreciation regulation. AT&T at 3; MCI at 9. As the SBC LECs and other ILECs explained, the NPRM's proposals would provide only very minimal relief from regulation. See, e.g., SBC LECs at 17-18; GTE at 5; Bell Atlantic at 1, 4; BellSouth at 11-12.

[13] See, e.g., BellSouth at 15-16. See also Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry," filed July 15, 1998, at 50-51.

[14] Ad Hoc at 3; Florida at 8.

agreement to waive the low-end adjustment.[15] Ad Hoc adds only one other condition for such deregulation: that price cap ILECs waive any right to recover the depreciation reserve deficiency, such as by filing a takings clause claim under the Fifth Amendment.[16] Thus, for Florida and Ad Hoc, the half-dozen other situations described in the NPRM are not significant concerns. Certainly, as discussed in the SBC LECs' and other ILECs' comments, these situations do not justify depreciation regulation.[17] But, neither do the low-end adjustment or a takings clause claim.

At least one interexchange carrier, Sprint, agrees that depreciation should be deregulated, even if the low-end adjustment is not waived or eliminated.[18]

Under rate-of-return regulation, the Commission prescribed depreciation rates as a core component of its ratemaking process that assured ILECs that they would recover their investment over the plant's useful life. Under price cap regulation, costs are no longer supposed to be used to regulate rates, and thus, depreciation regulation no longer serves its original purpose.[19] Accordingly, the Commission should cease regulating depreciation, even though prescribed depreciation rates are still being used for some limited purposes identified in the NPRM. The value of prescribing depreciation rates for these limited purposes is clearly outweighed by the inequitable burden that depreciation imposes on the price cap ILECs. As Bell Atlantic points out, if one regulation's reliance upon another could prevent the latter's

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[15] Florida at 8.

[16] Ad Hoc at 3.

[17] See, e.g., USTA, Attachment A, at 13-19; BellSouth at 15-24.

[18] Sprint at iv.

[19] See 1998 Biennial Regulatory Review – Petition for Section 11 Biennial Review filed by SBC Communications, Inc., Southwestern Bell Telephone Company, Pacific Bell, and Nevada Bell, CC Docket No. 98-177, Notice of Proposed Rulemaking, FCC 98-238, released November 24, 1998, ¶4 (ii) & (iii).

elimination, no progress would ever be made in achieving the de-regulatory purposes of the 1996 Act.[20]

II. IN THE RARE EVENT OF A LOW-END ADJUSTMENT FILING, THE ACCESS FILING PROCESS WOULD ALLOW SUFFICIENT TIME TO REVIEW THE GENERAL REASONABLENESS OF DEPRECIATION.

AT&T and MCI contend that it would be impractical to review depreciation rates at the time of any low-end adjustment filings because it would "require the review of an unknown number of LEC depreciation filings each year in the limited time available for the review of access tariffs."[21] On the contrary, there is ample time during the five months of an access filing investigation to review the reasonableness of an ILEC's depreciation rates. Review of depreciation rates in this context should not become the equivalent of a full-blown depreciation prescription proceeding.[22] Rather, the Commission could rely on predetermined criteria or presumptions such as the rebuttable presumption, suggested by Bell Atlantic, of reasonableness of the economic depreciation rates used for external reporting purposes in audited financial statements prepared consistent with GAAP.[23] As Sprint observes, reliance on the external auditors provides the assurance that depreciation is reasonable. In addition, the Commission could assess the reasonableness without detailed analysis by simply comparing the depreciation rates used by comparable competing carriers, such as MCI and AT&T or by relying on industry studies such as those prepared by Technology Futures.[24]

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[20] Bell Atlantic at 8.

[21] AT&T at 17; MCI at 19.

[22] See Bell Atlantic at 6-7.

[23] Id. See also Sprint at iv, 14.

[24] Vanston, Hodges & Poitras, Transforming the Local Exchange Network: Analyses and Forecasts of Technology Change (2d ed. 1997).

While there is no reason to expect multiple low-end adjustment filings in the same year – given the rarity of such filings in the past – use of simplified review procedures would resolve MCI and AT&T's shared concern about an "unknown number of LEC depreciation filings."[25]

In any event, there is simply no reason to conclude that five months would not allow sufficient time to determine the reasonableness of two or more ILECs' depreciation rates, if the Commission uses truly simplified procedures.

III. COMMISSION-PRESCRIBED DEPRECIATION RATES OVERSTATE EARNINGS, AND THUS, ANY EVALUATION OF EARNINGS SHOULD NOT RELY ON PRESCRIBED DEPRECIATION RATES.

AT&T and MCI also share a concern that the Commission could not effectively monitor ILEC price cap performance without continuing to prescribe depreciation rates.[26] They assert that "premature deregulation of depreciation would allow LECs to charge excessive depreciation which would lower their earnings and mask the need for a higher productivity factor."[27]

Earnings levels are not supposed to be relevant under price cap regulation. Instead, prices are capped and ILECs are encouraged to improve their efficiency.[28] That is why the Commission has refused "to reinitialize access rates based on LECs' individual rates of return."[29] Thus, individual ILEC depreciation rates and rates of return should have no bearing on the productivity factor.

In fact, the Commission has stated that adjustments to the X-Factor from a performance review would be based on "industry-wide performance or other generic factors, rather than

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[25] AT&T at 17; MCI at 19.

[26] AT&T at 18; MCI at 5.

[27] AT&T at 18; MCI at 5.

[28] USTA Reply Comments, CC Docket No. 96-262, November 9, 1998, at 16.

[29] 1997 Price Cap Review Order, ¶167.

adjustments that are tied to a particular price cap incumbent LEC's interstate earnings."[30] Further, as the SBC LECs and USTA have shown, changes in depreciation do not cause any changes in the X-Factor, as it is currently computed.[31]

Consequently, a proper performance review should not depend upon outdated and burdensome rate-of-return depreciation prescription procedures for its success.

If earnings are considered for any purpose (not that they should), the backward-looking depreciation rates prescribed by the Commission do not provide an accurate measure of depreciation, especially compared to the forward-looking depreciation practices used by competitors. AT&T and MCI believe that price cap ILECs have excessive earnings when, in fact, those earnings are artificially overstated as a result of requirements such as the unreasonably low depreciation rates prescribed by the Commission. If, like their competitors, ILECs were allowed to use forward-looking, economic depreciation rates to calculate their earnings, there would undoubtedly be a significant decline in the Commission reported earnings.

However, rather than indicating a need for a higher productivity factor, the current level of reported earnings indicates that depreciation rates are too low and out of line with prevailing depreciation rates in the unregulated sector of the market.

While one possible, but inefficient, solution would be for the Commission to conduct a comprehensive review of its depreciation regulation and basic factor ranges to adopt a truly forward-looking approach, the SBC ILECs submit that forbearance or elimination of depreciation regulation is the only practical solution.[32] It is unrealistic to expect the Commission

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[30] Id.

[31] SBC LECs at 8-10; USTA, Attachment B ("Evaluation of the Effect of a Change in Depreciation Rates on the Commission's X-Factor.")

[32] SBC LECs at 16-23; USTA, Attachment A, at 8-9.

to keep up with the rapidly changing dynamics affecting ILECs' depreciation practices.[33] Depreciation rates quickly become outdated if they are not reviewed annually and the Commission's massive depreciation procedure is not an effective method of keeping up. Accordingly, the Commission should remove itself from the depreciation process and rely on independent auditors and GAAP to assure the reasonableness of depreciation, the same as the competitive market that price cap regulation is supposed to emulate.

IV. GAAP IS NOT BIASED IN FAVOR OF INVESTORS OR AGAINST CONSUMERS.

Relying upon the same reasoning, AT&T and MCI contend that GAAP would not be an adequate substitute for the Commission's depreciation regulation and would not "adequately protect consumers."[34] AT&T and MCI reason that "[i]n regulating depreciation, the Commission balances the interests of both investors and ratepayers";[35] whereas, "GAAP is governed by the 'conservatism' principle"[36] which they contend favors the understatement of net income and assets.[37] AT&T and MCI have a fundamental misunderstanding of not only the "conservatism" principle, but also of the role GAAP plays in financial reporting.

As AT&T and MCI should know from their own financial reporting, the primary purpose of GAAP is to ensure that a company does not present a misleading picture of its financial condition (i.e., not overstate or understate its asset net book values).

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[33] SBC LECs at 16-23 & Exhibit A at 13-19; USTA, Attachment A, at 8-9. Nonetheless, if the Commission does not grant forbearance, it needs to conduct a comprehensive review of all of its basic factor ranges and update them on a regular basis using a forward-looking, economic approach, as noted by the ILEC commenters. See, e.g., SBC LECs at 16-23; Ameritech at 5-6; 10-11; BellSouth at 6-7, 12; GTE at 15-16.

[34] AT&T at 21-22; MCI at 8.

[35] AT&T at 22; MCI at 8.

[36] AT&T at 21; MCI at 8.

[37] Id.

As Arthur Andersen recently stated in rebutting the same argument presented by MCI in the Accounting Biennial Review proceeding,

> The purpose of GAAP is to guard against material misstatements, including overstatements as well as understatements, in the financial statements. Financial statements prepared in accordance with GAAP are intended to present fairly, in all material respects, the financial position, results of operations and cash flows of the company. This "presents fairly" concept covers both the understatement and overstatement of financial results. Thus, both shareholders and ratepayers are protected via the effective application of GAAP. If GAAP were purely based on conservatism as Snavely King asserts, then the auditors' report would state that the financial statements present conservatively, not fairly, the company's financial results.[38]

The conservatism principle does not embody the understatement of assets. As the Financial Accounting Standards Board (FASB), which establishes GAAP and provides guidance for the application of GAAP, has stated:

> Conservatism in financial reporting should no longer connote deliberate, consistent understatement of net assets and profits. The Board emphasizes that point because conservatism has long been identified with the idea that deliberate understatement is a virtue. That notion became deeply ingrained and is still in evidence despite efforts over the past 40 years to change it.[39]

Contrary to MCI's suggestions, the correct view of conservatism is stated as follows:

> Few conventions in accounting are as misunderstood as the constraint of conservatism. Conservatism means when in doubt choose the solution that will be least likely to overstate assets and income. Note that there is nothing in the conservatism convention urging the accountant to understate assets or income. Unfortunately it has been interpreted by some accountants to mean just that. All that conservatism does, properly applied, is to give the accountant a guide in difficult situations, and then the guide is a very reasonable one: refrain from

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[38] "Supplement to July 15, 1998 Position Paper: Accounting Simplification in the Telecommunications Industry", at 11, filed with Letter dated November 10, 1998 from Mr. Carl R. Geppert, Arthur Andersen LLP to Ms. Magalie Salas, FCC ("Arthur Andersen Whitepaper Supplement").

[39] FASB, Original Pronouncements: Accounting Standards as of June 1, 1998, Volume II, at 1042, ¶93.

> overstatement of net income and net assets.[40]

Besides, conservatism is not the only GAAP principle that governs depreciation. There are a number of GAAP principles that govern depreciation. The matching principle,[41] for example, is a primary principle for determining depreciation. The matching principle requires that depreciation expense be allocated to the periods during which the related assets are expected to provide benefits. Even NARUC has acknowledged that the matching principle governs depreciation.[42] Also, the FASB's explicit guidelines regarding the qualitative characteristics of information, such as the need for information to be representationally faithful, verifiable and neutral,[43] govern depreciation. These are just a few of the principles that should be considered when determining depreciation lives and rates in accordance with GAAP.[44]

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[40] Kieso & Weygandt, Intermediate Accounting 51 (John Wiley & Sons 8th Ed. 1995) (emphasis omitted).

[41] The matching principle requires that expenses be matched or reported in the same accounting period as are the revenues that were earned as a result of the expenses. Statement of Financial Accounting Concepts No. 5, Financial Accounting Standards Board, December 1984, ¶85, states as follows:

> Further guidance for recognition of expenses and losses is intended to recognize consumption (using up) of economic benefits or occurrence or discovery of loss of future economic benefits during a period. Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.

[42] NARUC, Public Utility Depreciation Practices 43 (1996) ("The accounting principle upon which depreciation is based is the matching principle.")

[43] Statement of Financial Accounting Concepts No. 5, Financial Accounting Standards Board, December 1984, ¶63. The FASB stated "An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are: . . . Reliability – The information is representationally faithful, verifiable, and neutral." Id.

[44] For a discussion of other principles, see Arthur Andersen Whitepaper Supplement at 12.

These and the numerous other GAAP principles serve to protect all who may rely upon audited financial statements prepared in accordance with GAAP.[45] Thus, contrary to AT&T and MCI's mischaracterization of the "conservatism" principle, GAAP is not biased in favor of investors, nor against ratepayers. Accordingly, under the oversight of independent auditors, GAAP would provide adequate protection for consumers, especially in view of the constraints of price cap regulation.

V. DEPRECIATION REGULATION HAS CREATED A LARGE DEPRECIATION RESERVE DEFICIENCY.

AT&T and MCI contend that the ILECs have "a depreciation reserve surplus, not a deficiency."[46] Thus, they conclude that the Commission's depreciation regulation has been "accurate and fair"[47] and that the Commission's prescribed factors are "forward-looking and unbiased."[48] As explained in detail in the SBC LECs' Comments, the Commission's depreciation prescription has been backward-looking as it is based almost entirely on historic data such as retirement data and past mortality experience.[49] Other ILEC commenters and Arthur Andersen agree. For example, Ameritech states that, "While Ameritech agrees that the Commission has changed its methods, . . . the use of forward-looking factors has not been adopted."[50] The NERA affidavit concludes that "prescribed depreciation parameters . . . cannot produce forward-looking costs."[51]

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[45] See BellSouth at 4-5.

[46] AT&T at 24; MCI at 21.

[47] AT&T at 23.

[48] MCI at 22.

[49] SBC LECs at 12-13, 18-20.

[50] Ameritech at 5-6.

[51] USTA, Attachment A, at 19.

AT&T and MCI's contention that there is a surplus is mainly based on the Commission's own comparison of book reserves to theoretical reserves, both of which were calculated using the backward-looking Commission-prescribed parameters. One would not expect to find much of a deficiency using the Commission's own artificially low depreciation rates. The SBC LECs' Comments showed that SWBT alone has a true depreciation reserve deficiency of almost $4 billion by calculating the theoretical reserve using the forward-looking economic depreciation rates that the SBC LECs use for external financial purposes[52] -- which, incidentally, are comparable to the depreciation rates used by the SBC LECs' competitors, such as AT&T and MCI, for the same or very similar assets. GTE states that its deficiency is over $6 billion.[53] Arthur Andersen estimates that the true deficiency for all of the RBOCs and GTE is $34 billion.[54]

While AT&T and MCI claim there is a surplus, Ad Hoc acknowledges that there is a depreciation reserve deficiency and asserts that it is "perhaps the greatest exposure end users would face from the deregulation of depreciation."[55] As the SBC LECs and other ILEC commenters explained, continuing to regulate depreciation only exacerbates the problem; whereas, forbearance from regulation shifts responsibility for any new deficiencies to the ILEC.[56]

Ad Hoc recommends that the Commission apply its "Make Whole or Make Money" proposal so that if ILECs choose to "make money," they must waive any right to recover the

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[52] SBC LECs at 25 n.67. This proper method of calculating the depreciation reserve deficiency is also explained in detail in the Andersen Whitepaper Supplement filed on November 10, 1998, at 16-17.

[53] GTE at 5.

[54] Arthur Andersen Whitepaper Supplement at 16-17.

[55] Ad Hoc at 7.

[56] See, e.g., SBC LECs at 14-16; BellSouth at 23.

deficiency, while getting forbearance from depreciation.[57] The main problem is that Ad Hoc's "Make Whole or Make Money" proposal is severely flawed, as explained in the SBC LECs Reply Comments filed November 9, 1998 in CC Docket No. 96-262, which are incorporated herein by reference.[58] As the SBC LECs explained there, Ad Hoc's "make money" option would not really allow ILECs to make any money because Ad Hoc proposes that the Commission would prescribe access rates at TSLRIC levels.[59]

A further flaw in Ad Hoc's attempt to apply this framework to depreciation is that Ad Hoc incorrectly assumes GAAP would require ILECs to forego the recovery of depreciation reserve deficiencies. Most price cap ILECs have already taken a write-down on their external financial books when they discontinued SFAS 71. GAAP does not require any further action,

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[57] Under Ad Hoc's "make whole" option, as applied to depreciation, it contends that full-blown depreciation studies and filings are necessary to enable other parties "to effectively rebut ILEC takings claims." Ad Hoc at 9. Similarly, GSA argues that, if the Commission adopts the NPRM's limited proposals, the Commission needs to continue collecting more underlying data than would appear in the four proposed summary exhibits. GSA at 4-5. Given that depreciation regulation is no longer necessary for purposes of routine regulation of price cap ILECs, the Commission should collect depreciation data on a strictly "as needed" basis. The Commission should not impose burdensome depreciation study or reporting requirements when they are not routinely used for any purpose, especially not on the theory that the information might have some speculative value on some uncertain future date. In any event, it would be pointless to continue collecting detailed depreciation data for the purposes described by Ad Hoc and GSA. First, when a takings case or embedded cost recovery proceeding is initiated, the Commission can obtain the necessary data through discovery or other requests. Second, future depreciation data should not be relevant if the Commission ceases regulating depreciation and imposing unreasonably low depreciation rates and long lives. GSA's data collection is pointless because the Commission should not continue micro-managing depreciation ranges using a "one-size-fits-all" backward-looking approach. However, GSA's comment illustrates why the NPRM's proposal to reduce regulation by only a small increment will not work and will not provide virtually any relief. Because the Commission would retain control under the NPRM's "partial" regulation proposal, the Commission would find it necessary to continue investigating the data underlying the summary exhibits, as GSA's suggestion implies, with the end result being virtually the same amount of regulation as before.

[58] SBC LECs Reply Comments, CC Docket No. 96-262, filed November 9, 1998, at 39-40.

[59] Id.

absent additional asset impairments. The write-down for GAAP purposes does not affect ILECs' right to recover the reserve deficiency.

In effect, Ad Hoc contends that companies subject to GAAP are not guaranteed recovery of depreciation reserve deficiencies. In making this contention, the Ad Hoc Committee is ignoring the unique nature of the ILECs' reserve deficiencies. Their reserve deficiencies are fundamentally different from write-offs unregulated companies have taken. These deficiencies are the direct result of Commission actions. The Commission constrained capital recovery by prescribing depreciation lives significantly longer than those the ILECs requested (or would have chosen, given that freedom). These Commission decisions have left recovery of these assets at risk. In the competitive environment, the Commission is not able to guarantee the future revenue it foresaw when it set unrealistically long depreciation lives.

Companies that set their own depreciation lives have the opportunity to avoid the type of reserve deficiency that the ILEC's are experiencing. If these companies set realistic depreciation lives, then depreciation expense matches consumption of the asset. To the extent unforeseen market and technology changes happen, write-offs may be necessary. The unregulated company has had the *opportunity* to avoid that write-off and therefore bears the risk. The SBC LECs and the other ILECs were not given that opportunity and, therefore, should not be precluded from seeking recovery of the reserve deficiency in the future.[60]

It would be improper for the Commission to impose a condition, as suggested by Ad Hoc, that the ILECs waive the recovery of billions of dollars of deficiencies accumulated over many

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[60] Ad Hoc contends that the "bulk" of the ILECs' investment "was acquired 'after ILECs were well aware of impending changes in marketing and regulatory environments and entirely capable of managing their construction and investment programs to accommodate such changes.'" Ad Hoc at 10. This argument suggests an absurd revisionism of the history of recent regulation. Without debating the factual details underlying this contention, ILECs certainly have not had the freedom to ignore their franchise or service quality obligations, even if there were any reason or incentive for them to do so. From a number of perspectives, including enforceable obligations, ILECs have not had the option to avoid maintaining and investing in their networks, as Ad Hoc's argument suggests.

years. Depreciation regulation is no longer necessary for price cap ILECs and should be eliminated. Conditioning the elimination of this one particular area of Commission regulation on the ILECs agreement to relinquish their constitutional rights would be an overbroad and improper condition, aside from the fact that ILECs would not receive just compensation.[61]

VI. RESTRUCTURING NET SALVAGE TO BE CONTRARY TO THE GAAP EXPOSURE DRAFT WOULD BE POOR POLICY.

While the SBC LECs urge the Commission to cease prescribing depreciation factors altogether, including net salvage factors, the SBC LECs agree with Sprint and other commenters that such a fundamental change in the structure of depreciation regulation as the elimination of net salvage would be a "poor policy" decision at this time.[62] At a time when the Commission should eliminate depreciation regulation altogether, it makes little sense to adopt such a fundamental restructuring, especially given that treating net salvage as a current expense would be contrary to the GAAP procedure proposed in Exposure Draft 158-B. Instead of adopting such a change when the same principle is being reviewed by FASB, the Commission should wait until FASB adopts a binding accounting principle. If the Commission is still involved in prescribing depreciation rates at that time, it can consider any necessary changes.

AT&T and MCI both support the Commission's proposal to require net salvage to be treated as a current expense.[63] They claim this would simplify one complex component of the depreciation process, but they ignore the problems that conflicting GAAP requirements would create, as BellSouth explains:

> [Assuming the Exposure Draft is adopted,] there will be an immediate difference in the accounting required by GAAP and the accounting required by Part 32 for removal/retirement costs. Carriers would then be faced with an increase in the

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[61] Cf. Nollan v. California Coastal Comm'n, 483 U.S. 825, 837-42 (1987); Dolan v. City of Tigard, 512 U.S. 374, 386-88 (1994).

[62] Sprint at 7-9.

[63] AT&T at 8; MCI at 13.

cost of regulation due to the additional expense of tracking removal/retirement costs per the Commission's regulations and separately per GAAP.[64]

AT&T and MCI also both insist that the impact would be negligible.[65] MCI states, "For the six-year period, net salvage has been negligible relative to BOC investment."[66] Attachment 1 to MCI's comments shows net salvage as a percent of total investment with values that are less than a tenth of one percent. This is a misleading argument and it misses the main point of the conflict with GAAP.

Net salvage as a percent of total investment is a meaningless calculation. Net salvage as a percent of retirements is the proper way to understand the impact of net salvage. Salvage and cost of removal are triggered by a retirement. Net salvage as a percent of retirements is much higher than the amounts shown by MCI. For example, as a percent of retirements, SBC LECs have averaged -2% net salvage over the years 1992 through 1997. For the SBC LECs, a -2% net salvage rate translates into over $1 billion in future liability.[67] MCI's argument that this is negligible is simply wrong.

GSA, which also endorses the Commission proposal, states that current practices for estimating salvage and cost of removal "contain a bias towards overstatement."[68] GSA states that current practices result in a net salvage "ratio that incorporates past inflation and, when applied as an adjustment to the depreciation rate, projects that inflation into the future."[69] This argument grossly simplifies the factors affecting future net salvage estimates. The removal of

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[64] BellSouth at 14.

[65] MCI at 13; AT&T at 8.

[66] MCI at 13.

[67] Given the SBC LECs' investment of $58 billion, a -2% net salvage rate translates into over $1 billion of future liability.

[68] GSA at 7.

[69] Id.

many outside plant assets is a highly labor intensive activity, making the cost of removal subject to an annually increasing cost of labor. This increase in labor cost is not the only factor affecting the cost of removal. The nationwide movement for increasingly stringent environmental control and protection will continue to drive these costs ever higher. For example, poles treated with chemicals, such as creosote, need above-ground storage after removal; poles can no longer be burned or buried. Underground lead sheath cables require special hazardous material procedures. It is important to consider all of these factors in estimating future net salvage. If anything, the current Commission ranges, based on historical trends rather than forward-looking analysis, underestimate the impact of the totality of the circumstances affecting net salvage.

In any event, aside from forbearing from prescribing depreciation lives and salvage for price cap ILECs, in view of the pending GAAP exposure draft, the Commission should not proceed with such a significant and conflicting change in the treatment of net salvage at this time.[70]

VII. THE COMMISSION HAS NOT CONDUCTED THE COMPREHENSIVE REVIEW THAT IS NECESSARY IF THE COMMISSION CONTINUES ANY REGULATION OF DEPRECIATION.

GSA declines to agree or disagree with the proposal to reduce the low end of the life range for digital switching because it does not believe the NPRM has furnished enough information to evaluate the proposal.[71] While the SBC LECs submit that ample public information is available to support a reduction of the low end of not only the digital switching range but a number of other categories' ranges, the SBC LECs agree with GSA in the sense that the NPRM does not reflect sufficient analysis and re-evaluation of the Commission depreciation requirements. If the Commission is going to continue regulating depreciation of any ILEC, it needs to conduct a comprehensive review of all of the basic factor ranges.

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[70] Of course, to the extent the Commission continues to prescribe depreciation rates, it should adopt a forward-looking approach to lives as well as net salvage.

[71] GSA at 6.

The NPRM merely states that its review of recent industry data provides no evidence that other ranges are too long or too short, but the NPRM does not describe what industry data it reviewed or provide any "refined and relevant information that supports"[72] its preliminary conclusion that other existing ranges are not in need of change. It appears, however, that in whatever analysis the Commission did, it continued to use a backward-looking approach because the only "recent industry data" it refers to is ARMIS data on retirement rates.[73] The SBC LECs and other ILECs have provided ample information to support a re-examination of other ranges, and other information is publicly available or available to the Commission as a result of recent represcription proceedings.[74] Much of this forward-looking data is analyzed in the 270-page report published by Technology Futures in 1997,[75] although more recent developments should also be considered. The Commission's current life ranges are based on historical retirement data that is several years old. An approach that applies regulatory inertia to maintain the status quo will not work, if the Commission does not choose to remove itself from the depreciation process.

To the extent that the Commission does not grant forbearance, the SBC LECs urge the Commission to undertake the comprehensive review of its depreciation requirements and basic factor ranges that current and future conditions require.[76] If regulation of depreciation is not completely eliminated, the Commission also must adopt a procedure for updating its basic factor ranges and depreciation requirements on a regular basis each and every year.

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[72] GSA at 6.

[73] NPRM, n.42.

[74] SBC LECs at 16-23, Exhibit A at 13-19; Ameritech 9-11; BellSouth at 12; Sprint at 6. See also Vanston, Hodges & Poitras, Transforming the Local Exchange Network: Analyses and Forecasts of Technology Change (2d ed. 1997).

[75] Id.

[76] If the Commission does not believe it has sufficient data to justify a reduction in the low end of the ranges of other accounts, it should initiate a proceeding early in 1999 to request further input.

VIII. CONCLUSION.

Because there is no good reason for purposes of price cap regulation or otherwise to continue prescribing price cap ILECs' depreciation rates, the Commission should grant USTA's Petition for Forbearance. Conditions, such as waiver of the low-end adjustment, should not be imposed because the Commission can review the general reasonableness of depreciation on a case-by-case basis in the event of a low-end adjustment filing or one of the other limited situations described in the NPRM. Any such review should rely on the forward-looking economic depreciation rates used, under the scrutiny of independent auditors, for external reporting purposes consistent with the balanced principles of GAAP. To the extent the Commission does not remove itself completely from the depreciation process, it is essential that the Commission conduct a comprehensive review of its depreciation requirements and basic factor ranges using a forward-looking analysis that permits ILECs to use depreciation parameters comparable to those of their competitors.

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December 8, 1998

Appendix A

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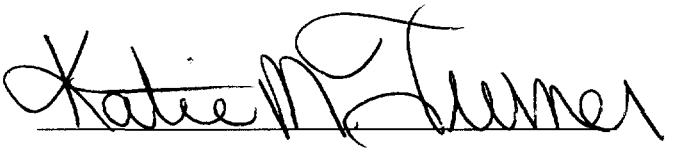
AT&T Corporation (AT&T)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Corporation (BellSouth)
Cincinnati Bell Telephone Company (CBT)
Florida Public Service Commission (Florida)
General Services Administration (GSA)
GTE Service Corporation (GTE)
MCI Worldcom, Inc. (MCI)
Sprint Corporation (Sprint)
United States Telephone Association (USTA)
Virginia State Corporation Commission Staff (Virginia)

CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "CC DOCKET NO. 98-137, REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY, PACIFIC BELL AND NEVADA BELL IN THE MATTER OF 1998 BIENNIAL REGULATORY REVIEW – REVIEW OF DEPRECIATION REQUIREMENTS FOR INCUMBENT LOCAL EXCHANGE CARRIERS AND ASD 98-91, FORBEARANCE FROM DEPRECIATION REGULATION OF PRICE CAP LOCAL EXCHANGE CARRIERS" in CC Docket No. 98-137 has been filed this 8th day of December, 1998 to the Parties of Record.



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